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VIA ELECTRONIC FILING

The Honorable Comer H. “Randy” Randall, Chairman
Public Service Commission of South Carolina
101 Executive Center Drive
Columbia, South Carolina 29210

Re: Procedure to Address Treatment of Deferrals (See Page Number 5 of Order No. 2019-341), Docket No. 2019-233-A

Dear Chairman Randall:

Dominion Energy South Carolina, Inc. (“DESC”) commends the Commission for providing stakeholders with the opportunity to respond to the issues concerning accounting deferrals that have arisen from Docket Nos. 2018-318-E and 2018-319-E. These issues have broad implications for regulation in South Carolina and are worthy of serious consideration. Inasmuch as DESC was not a party to the two dockets in question, it is not familiar with all of the details concerning the matters in dispute. However, DESC will comment based on its understanding of the issues as reflected in the record of the hearings and Order Nos. 2019-341 and 2019-323.

The comments below

- Explain how deferral accounting orders are used to benefit customers and the regulatory process;
- Discuss why the approach reflected in Order Nos. 2019-341 and 2019-323 would damage the effectiveness of deferral accounting orders as a regulatory tool and cause the Commission to lose the authority and flexibility it has traditionally exercised for the benefit of customers;
- Show that the limitations in question are contrary to fundamental principles of accounting and cost of service rate making and are logically inconsistent; and
- Propose that the Commission consider a regulation to address these matters.

These comments begin with a discussion of the practical issues that regulatory deferrals address. They then discuss the specific ways that the approach reflected in Order Nos. 2019-341 and 2019-323 misses the mark and how that situation can be remedied.

1. Overview of Regulatory Deferrals and the Problem of Regulatory Lag

In regulatory accounting, deferrals exist to address regulatory lag, which is the gap between when a utility experiences a cost increase and when that increase is reflected in rates. With limited exceptions, costs that arise after the close of the test year in one rate case are not included in rates until after the next rate case order takes effect.¹ Because of that delay, a utility's returns deteriorate as it invests in new projects and programs and absorbs major expenses between rate orders. As returns deteriorate, the utility files for new rates. When new rates go into effect, regulatory lag ends for the costs incurred through the end of the test period in that case. Regulatory lag continues for the increased costs experienced after that date.

It is interesting to note that for the largest element of electric costs (fuel costs and purchased power costs) and for programs in which the General Assembly and Commission have sought to encourage utility spending (Distributed Energy Resources and Demand Side Management), ratemaking mechanisms subject to annual adjustment and true-up are the rule.² These mechanisms are specifically designed to minimize regulatory lag which would otherwise restrain investment or result in excessive frequency of repeated rate cases.

Regulatory lag affects all aspects of a utility's business. Deferral accounting orders, however, are concerned only with one aspect of regulatory lag, the regulatory lag which is associated with major new projects, programs or expenses. Specifically, deferral accounting orders are used to address the pressure that regulatory lag would otherwise put on a utility to delay undertaking beneficial projects and programs between rate cases or in the face of major new expenses to file rate cases more frequently and earlier than would otherwise be optimal. Unless addressed in a constructive manner, regulatory lag can distort utility decision making, although DESC is careful to ensure that public and employee safety is not compromised. While projects that must be undertaken to ensure public and employee safety and to ensure compliance with laws and regulations are not delayed, as discussed below, regulatory lag can result in other beneficial projects or programs being delayed or in rate cases being filed more frequently than is optimal.

To understand why this is the case, it is helpful to review three common approaches that utilities can take to respond to regulatory lag. The first approach to resolving regulatory lag is filing repeated rate cases in rapid succession. Doing so reduces regulatory lag by limiting the cost increases that can accumulate between rate orders. Under this strategy, the utility files rate cases as soon as possible after the costs of major projects, programs or major expenses arise and as often as possible thereafter. But few stakeholders—customers, utilities, regulators, political leaders and the public alike—are comfortable with rate cases being filed in rapid succession. Repeated rate

¹ In base rate cases for electric utilities, the exceptions are for known and measurable changes occurring outside of the test period.

² See, e.g., S.C. Code Ann. § 58-27-865; S.C. Code Ann. § 58-37-30 (mandating annual reporting).

cases also increase the cost and burden of regulation, the consequences of which are ultimately borne by customers.³

A second way to reduce regulatory lag is for the utility to delay implementing certain major projects or programs until rate cases are imminent. While this option is not available to projects that support safety or compliance with regulations, the downside here is that projects or programs may be delayed even if they would benefit customers by creating long-term improvements in efficiency, reliability and customer service. (Examples are given below.) Customers and the utility systems that serve them can suffer when such projects are delayed. And, the larger (and therefore the more potentially beneficial) the project or program, the greater the unrecovered costs that result from undertaking it. In addition, opportunities to take advantage of favorable market conditions, discounted assets coming on the market or construction windows can be put at risk if the underlying investment is delayed.

In effect, the 'delay' approach to minimizing regulatory lag incentivizes the utility to manage for short-term cost containment rather than long-term efficiency, reliability, and economy. Customers lose when this happens.

The third response to regulatory lag is a deferral accounting order as allowed by S.C. Code Ann. § 58-27-1540. It allows the utility to defer certain costs of projects, programs or major expenses between rate cases. These costs include the costs that the utility must bear in financing the amounts deferred which the utility must support by issuing a combination of debt and equity capital.

A deferral accounting order should provide reasonable assurance that the utility will be allowed to recover these costs when a future rate order is issued. As described below, under the applicable accounting rules, the utility cannot recognize the deferral if the utility is not reasonably assured that future recovery is probable.

If structured properly, a deferral accounting order removes or reduces the incentive for the utility to delay implementing beneficial projects or programs between rate cases. It also reduces pressure for filing rate cases early or in rapid succession after the projects or programs are implemented or after major new expenses are incurred. All other things being equal, a properly structured deferral order can change the timing, but not the net present value, of the costs recovered. This takes regulatory lag largely off the table as a consideration in utility decision making, which is good for all involved.

An example of the appropriate use of a deferral accounting order is Order No. 2011-80 that the Commission issued at the request of Duke Energy Carolinas in 2011 to allow it to defer non-fuel operations and maintenance costs, and depreciation along with cost of capital on the environmental upgrades to its Cliffside Unit 5:

"The Petition shows that the Company's earnings for the twelve-month period ending June 2010 were below the authorized equity rate of return allowed by this Commission. Duke Energy Carolinas will suffer an additional sizeable decline from its allowed equity rate of

³ As the Commission recognized in Order No. 2019-341 and Order No. 2019-323, a rate case can cost a utility millions of dollars in both internal and external costs, and the costs incurred by the ORS and other parties are in addition to that amount.

return in 2010 and 2011 unless the Company is permitted to defer the costs requested. Avoiding such an adverse earnings impact is important to assure Duke Energy Carolinas can achieve sustainable financial results necessary to maintain access to needed capital on reasonable terms, particularly during this time of global financial and credit crisis.”

Order No. 2011-80 at p.2.

It is a testament to the unique value of deferral accounting orders to the regulatory process that the Financial Accounting Standards Board (“FASB”) has specifically provided for the recognition of the regulatory assets that result from such orders. See Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980-340-25-1. ASC 980 gives effect to deferral accounting orders for financial reporting purposes, so long as certain conditions are met.

If the utility is allowed to recover less than the full cost associated with a deferral, including financing costs, then all other things being equal, it is in the utility’s interest to forego requesting the deferral order and instead either to delay the expenditure or file for immediate and regular rate cases to capture the cost of the project, program or expense. In this context, the utility’s full cost of the deferral would include the cost of financing the amount deferred until it is fully recovered.⁴ Similarly, the longer the deferral and amortization period for the costs deferred, the longer that the deferred costs must be financed, and the greater the financial impact of denying the utility full capital costs.

The recovery of financing costs during the amortization period is best done by including the unrecovered balance of the regulatory deferral account in rate base where it is subject to cost of capital for ratemaking purposes. There have been cases where DESC has not sought to include financing costs in the amount deferred or to recover financing costs during the amortization period. Typically, the deferrals in question involved relatively manageable amounts and short deferral periods. But the larger (and perhaps more beneficial) the project or program, and the longer the deferral and amortization period, the more important it is to the utility that it receive recovery of its full cost to avoid an unacceptable impact on returns due to the deferral.

Reliance on future recovery of deferred costs is the core purpose of a deferral accounting order. From an accounting standpoint, recognizing the deferral is appropriate only if the utility can rely on the deferral accounting order as establishing a reasonable probability that the deferred costs will be recovered through future rates. See Accounting Standards Codification (ASC) 980-340-25-1.⁵ If such reliance is not reasonable, the cost cannot be deferred and recovered later.

Therefore, as a practical matter and a matter of accounting rules, a deferral accounting order is only effective to accomplish its intended purpose if a utility can reasonably rely upon it as

⁴ Financing costs, in this context, include financing the cost on the items while being deferred and financing costs on the full balance of regulatory assets while deferred amounts are being amortized into rates. In both cases, the utility carries the deferred amount on its balance sheet and has incurred long-term financing to support that amount.

⁵ This is not to say that accounting orders are conclusive of all matters concerning a project, program or cost. The recovery of deferred costs is subject to review of the reasonableness and prudence of the project, program or expense as a whole and the specific costs paid or incurred.

providing assurance that future rate recovery of the amounts deferred is probable. If reliance is not warranted, the deferral accounting order has little value.

2. Practical Examples of Using Deferral Accounting to Overcome Regulatory Lag

Below are several practical examples of how deferral accounting orders have been used to mitigate regulatory lag:

- In 2008, DESC received a deferral accounting order concerning the construction and testing of a major environmental upgrade (principally SO₂ scrubbers) at the Wateree electric generating station. See Order No. 2008-741. A retail rate proceeding intended to coincide with the commercial operation date of the Wateree upgrades was filed in 2010. However, delays arose in the post-construction testing of the Wateree upgrades, and they were not placed in service in time to be reflected in rates during that rate proceeding. Because of the size of the investment involved (\$280 million), DESC seriously considered filing another rate case immediately upon the Wateree scrubbers coming on line to capture depreciation, O&M costs, taxes and insurance. Instead, the Commission allowed DESC to defer the operating and maintenance costs and depreciation on the units until the next rate proceeding. This avoided the necessity for back-to-back rate increases in 2010-2011. These deferred amounts were to be amortized into rates over 23 years with the unamortized deferral being allowed in rate base over the recovery period.
- In 2013, DESC decided to retire Canadys Units Two and Three. These coal-fired generating units were fully operational but were too small to support environmental upgrades going forward. Significant ongoing capital investment would have been required to continue to maintain them for reliable operation. DESC determined that it was in customers' financial interest to remove those units from operation in 2013. However, there were significant costs involved in retiring those units and replacing their capacity. No rate case was on the horizon to recover those costs in a timely manner. Rather than delaying retirement of Canadys, which would not have been in customers' best interest, DESC requested an accounting order allowing the deferral of the additional costs for consideration in a future rate case. The Commission granted that request in Order No. 2013-649.
- In 2019, DESC decided to begin the installation of Advanced Metering Infrastructure (AMI) across its service territory. See Docket No. 2019-241-E. However, given the planning and procurement required for the program, little investment related to the program is likely to be in place during the test year for the anticipated 2020 rate proceeding. It is unclear when the next rate case would be filed. Rather than delay this important initiative until closer to the next rate proceeding, DESC sought an accounting order to defer the additional costs. Preparations are now underway to install AMI system-wide.
- Multiple orders have been issued allowing utilities to defer the major costs associated with restoration of service after hurricanes and other major storms. See Order No. 2017-52; Order No. 2019-126. Allowing storm damage deferrals is particularly beneficial since filing a rate case while the customers are still recovering from the economic effects of a catastrophic storm is not likely to be well received.

3. The Approach to Deferrals Taken in Docket Nos. 2018-318-E and 2018-319-E

The approach to deferrals taken in Docket Nos. 2018-318-E and 2018-319-E was set forth in the testimony of ORS's audit witness. In sum, the utility was denied the opportunity to recover its cost of capital on the deferred depreciation, taxes, insurance and other operating maintenance expenses associated with multiple deferrals. In addition, the utility was not allowed to recover the cost of capital that was booked to these deferred costs while the deferral orders were in place.⁶ Recovery of those latter amounts—the deferral of which was expressly authorized by duly issued accounting orders—was disallowed.

In the end, the approach adopted in Docket No. 2018-319-E denied the utility the right to recover its cost of capital on more than half of the cumulative balance of previously-approved deferrals.⁷ In addition, very long amortization periods were set for the deferred amounts which had the effect of increasing the amount of financing costs that the utility was not allowed to recover.

The overarching policy issue is this: If the approach reflected in Order Nos. 2019-341 and 2019-323 becomes established policy, then the practical utility of deferral accounting orders will be deeply degraded, and the Commission will lose an important tool for managing the regulatory process in the interest of customers.⁸ There will be times when deferral orders based on the principles adopted in Order Nos. 2019-341 and 2019-323 will simply not be effective to counteract the effect of regulatory lag where major projects or expenses are at issue. Applying the approach reflected in Order Nos. 2019-341 and 2019-323, there will be times when, as a practical matter, it will be impossible to use deferral accounting orders for the benefit of customers as the Commission has done in the past.

4. Counterarguments

Several counterarguments have been raised in an attempt to justify, as a matter of principle, denying utilities the ability to recover the full cost of capital incurred in a deferral. In one sense, these arguments are beside the point. If full recovery is not the standard, then utilities may choose not to rely on deferral accounting orders in managing their business. In that case, the benefits to customers of fewer rate proceedings and more timely implementation of beneficial programs or projects are lost.

⁶ To put this in perspective, the expenses that are deferred under a deferral accounting order are typically

- cost of capital associated with an investment,
- depreciation associated with an investment,
- taxes, insurance and other operating maintenance expenses costs associated with an investment,
- if no capital investment is involved, major operating and maintenance expenses not currently reflected in rates, and
- the cost of capital associated with the deferred depreciation, taxes, insurance and other O&M amounts.

The “price tag” of a capital project is itself already a capital cost and is automatically “deferred” in the sense that it is included in rate base and is being amortized over its useful life through depreciation. What is deferred under a deferral accounting order is the cost of capital on that “price tag” plus the associated depreciation, taxes, insurance and other operating maintenance expenses and the cost of capital associated with those amounts.

⁷ Docket No. 2018-319-E, Hearing Transcript Vol. 7, p. 1613.

⁸ [citation to follow]

However, the arguments advanced against full recovery of deferred costs contain major flaws that indicate the unfairness and logical inconsistency of those arguments. Furthermore, while these arguments have superficial appeal, they do not stand up to careful scrutiny. For those reasons, those flaws and inconsistencies are worth pointing out.

The first of these flaws concerns the argument that it is inappropriate under a deferral accounting order for a utility to recover its cost of capital associated with “noncapital” or “operation and maintenance” items. This argument is wrong both from a practical and a theoretical perspective.

From a practical standpoint, this argument ignores the fact that a utility in fact incurs a capital cost on any deferred item whether that item would be characterized as a capital or noncapital item in other contexts. The dollars associated with deferred depreciation, taxes, insurance, and other “operating maintenance expenses” are in no way distinguishable from the dollars associated with the underlying cost of the capital item itself or the deferred recovery of the utility’s cost of capital on that item (which ORS allows to be recovered because it is “capital related”). All deferred items, not recovered currently, whether “capital” or “non-capital” in other contexts, must be financed by the utility pending collection. Just as there is no free lunch, there is no free capital. There is cost of capital associated with each of these items.

Second, the argument is flawed as a matter of accounting. Regulatory deferrals convert costs that would otherwise be recovered through current rates into costs that are to be recovered over multiple years and thus must be financed over multiple years. Therefore, a deferral accounting order converts what would otherwise be expense items into capital items. This fact is reflected by ASC 980-340-25-1 which provides the criteria for recognizing a regulatory deferral and states that “[a]n entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense. . . .” Furthermore, “[i]f specified criteria are met, paragraph ASC 980-340-25-1 requires capitalization of an incurred cost that would otherwise be charged to expense.” ASC 980-340-25-5.

Therefore, asserting that financing costs should be denied for deferred expense items because those items are not “capital costs” is based on a misapplication of the relevant accounting rules. Although the deferred items are not components of property, plant and equipment, they become capital costs when they are deferred as a result of being recorded as a regulatory asset on the balance sheet and not being expensed as incurred.

Furthermore, the premise that the utility does not earn its full cost of capital on the funds used to finance expenses is equally flawed. The utility does in fact earn its full cost of capital on the funds used to finance expense items. It does so through the working capital component of rate base which provides for the recovery of the utility’s full weighted average cost of capital as applied to the funds used to cover current expenses before they are collected through rates.

Specifically, working capital is the capital required to cover the lag between payment of an expense item and collection of that expense through current revenue. In each rate proceeding, the Company computes the amount of working capital the utility must employ to cover its short-term obligations that are funded through current revenues. The Commission allows the utility to include that amount of working capital in rate base and to earn a return at the full weighted average cost of

capital. Thus, the utility earns a full return on the capital used to finance even the most short-term expenses.

As to both long-term capital items and short-term expenses, regulation properly allows the recovery of the utility's cost of capital on the amount financed. There is no distinction between the two.

Another flawed counterargument made in Docket No. 2018-319-E was that the utility involved could fairly be denied full recovery under an accounting order because it collects over a "billion dollars in operating revenues from South Carolina customers"⁹ and can look for the disallowed recovery from that revenue.

The inconsistency is clear to see. The purpose of a deferral accounting order is to defer costs that are not otherwise being recovered through current revenue. If a cost is being recovered through current revenue, there is no need for an accounting order. It is entirely inconsistent to say, on one hand, that a utility should be allowed to defer certain costs so that they will not be reflected in current revenue and then say that it is acceptable to deny the utility the right to later recover some part of those costs because they are in fact somehow being recovered through current revenue.

A further flawed argument made in Docket No. 2018-319-E was that less than full recovery should be allowed under deferral accounting orders to prevent them from being overused. If indeed there needs to be a check on the frequency or number of accounting orders, then the appropriate review and evaluation should take place before the orders are issued. In the case of each deferral accounting order at issue here, the Commission issued the requested order only after receiving a letter of no objection from ORS. It is not appropriate to destroy the practical utility of deferral accounting orders by making them non-compensatory after the fact. Nor is it appropriate to deny a utility the reasonable recovery of deferred amounts after it has relied on deferral accounting orders to delay filing rate proceedings or to proceed with expensive projects. This approach is both punitive and retroactive.

In Docket No. 2018-319-E, a primary argument made by ORS on surrebuttal was to point out that 40% of the utility's rate increase request in that docket was associated with deferred items. That may have been the case; however, the percentage of the overall rate increase should not speak to the recoverability of the costs in question. The long-term value of deferral accounting orders, and their future potential benefit to customers, should be the primary considerations.

5. A Proposed Response by Regulation

DESC would respectfully submit that the appropriate response to the issues raised in Order Nos. 2019-341 and 2019-323 is for the Commission to state unequivocally that the principles applied there are limited to that proceeding and will not be applied generally. In addition, it could be helpful for the Commission to adopt a regulation pursuant to S.C. Code Ann. §§ 1-23-110 *et seq.* authoritatively addressing issues concerning deferral accounting orders. Under the Administrative Procedures Act, before promulgating such a regulation, the Commission would give notice of a drafting period by publication and invite interested person to submit comments.

⁹ Docket No. 2018-319-E, Hearing Transcript, Vol. 7, p. 1617

Any proposed regulation should set forth the components of an application for a deferral accounting order, the key terms of standard accounting orders (including elements of costs, the cost of capital and amortization period) and would provide assurance that an accounting order, when issued, would be implemented in a way that comports with its terms as issued.

6. Conclusion

For the reasons stated above, DESC respectfully requests the Commission to issue an order recognizing that incorporating in Commission practice the principles related to deferral accounting orders as set forth in Order Nos. 2019-341 and 2019-323 would substantially hinder the ability of the Commission to act in the best interest of ratepayers going forward. DESC would further respectfully request the Commission to consider opening a docket for the issuance of a new regulation embodying the principles as set forth above.

Thank you for your consideration of these matters.

Respectfully submitted,

/s/Belton T. Zeigler

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